No. 14792

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

JACOB (JAY) PALEY and LILLIAN PALEY,

Respondents.

PETITION FOR REHEARING.

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To the Honorable William E. Orr, Richard H. Chambers, and Gilbert H. Jertberg:

The above-named appellees hereby respectfully request a rehearing of the appeal in the above-entitled cause for the following reasons:

1. The Court's decision erroneously applied alleged equitable considerations to the legal interpretation of Sections 182 and 183 of the Internal Revenue Code of 1939 as amended.

2. The Court's decision fails to follow the intent of Congress expressed in "Supplement F—Partnership" to the Internal Revenue Code of 1939 as amended.

3. The Court's decision erroneously relies on the decision of the Supreme Court of the United States in

Neuberger v. Commissioner, 311 U. S. 83, failing to recognize the basic changes in the partnership sections of the Internal Revenue Act of 1932 there involved and the Internal Revenue Code of 1939 as amended here involved.

I.

The Court's Decision Seems to Be Based Upon the "Equitable Maxim" That Tax Statutes Should Be Interpreted to Result in Maximum Taxation.

Taxpayer Jay Paley, in the years in question was a partner in the Arrowhead Springs partnership, which had recognized gains from the sale of 117(j) assets in excess of the recognized losses from such sales. Said taxpayer, and taxpayer Lillian Paley, had individual losses of the type descrirbed in 117(j) of the Internal Revenue Code, which exceeded the gains from the sale or exchange of such assets in the years in question. The Arrowhead Springs partnership filed a partnership return during the years in question in which it segregated capital gains and losses and ordinary net income or loss pursuant to Section 183 of the Internal Revenue Code of 1939 as amended. The Arrowhead Springs partnership had a net gain for the years in question from 117(j) transactions and pursuant to 117(j), included the net gain in its capital gains and losses. Taxpayer, Jay Paley, reported his distributive share of the partnership's ordinary net income and his distributive share of the partnership's capital gains and losses in his individual return. The question before the Court is whether respondents should pay a deficiency tax because the Arrowhead Springs partnership followed the provisions of 117(j) of the Internal Revenue Code of 1939 in determining the partnership's total capital gains. The Tax Court determined that there was no deficiency.

This Court reversed the Tax Court and refused to follow the formula required by Congress in Sections 182 and 183 of the Internal Revenue Code of 1939 in the reporting of partner's income from partnerships on the grounds that to follow that formula

> "would ascribe to Congress the intent that a taxpayer should benefit twice from §117(j) in the same year . . . We find nothing to indicate that Congress intended such an inequitable . . . application of §117(j)." (Op. p. 5.)

So-called equitable considerations compelled the Court to ignore the mandate of Congress that (1) "The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual. . . ." (Sec. 183 of the Int. Rev. Code of 1939 as amended), and (2) "If . . . the recognized gains upon sales . . . of property used in the trade or business . . . held for more than six months . . . exceed the recognized losses from such sales . . . such gains and losses shall be considered as gains and losses from sale . . . of capital asets held for more than six months . . ." (Sec. 117(j), subpar. 2 of the Int. Rev. Code of 1939 as amended), and (3) "In computing the net income of each partner, he shall include . . . (b) as part of his gains and losses from sales . . . of capital assets held for more than six months his distributive share of the gains and losses of the partnership from sales . . . of capital assets held for more than six months." (Sec. 182, Int. Rev. Code of 1939 as amended.)

With all due respect to this Court, it is unreasonable to require a taxpayer to pay approximately $40,000 of additional taxes and interest by a judicial decision based upon the "equitable maxim" that courts of law should

interpret tax statutes in a way which results in maximum taxation because any other interpretation would be inequitable to the Government. This is new to any accepted principles of law applicable to the interpretation of tax statutes. Certainly, a strained interpretation of a statute should not be adopted, nor a logical one disregarded because the individal taxpayer will pay more or less taxes. The results in terms of the amount of tax to be paid should not control the legal interpretation of tax laws, the very enactment of which requires amendment. Nor should the absence of a statute to cover a particular situation be a rule of penalty imposed by judicial decision upon the taxpayer.

The Court's concern about the taxpayer's position being inequitable seems to come from the argument advanced by the Commissioner on pages 16 and 17 of his brief. The Commissioner was concerned with the fact that in the hypothetical situation stated by him the taxpayer "would pay not one cent in taxes, although he had netted $50,000 in actual income." If this argument, which was adopted by the Court, is carried to its ultimate conclusion, then the Courts may disregard the internal revenue sections allowing special treatment for the sale of capital assets. To use the Government's figures, if an individual in any one tax year sold capital assets for $100,000 and in the same year suffered an ordinary loss of $50,000, the taxpayer would put $50,000 in his pocket and "would not pay one cent in taxes" and this, so the argument goes, could not have been intended by Congress because it is inequitable to the Government.

Certainly, when the Tax Court has determined a question in favor of the taxpayer, that determination should not be reversed because the Tax Court's interpretation would be inequitable.

Neither the Commissioner nor the Second Circuit Court of Appeals thought that the argument which taxpayers are advancing here was unsound or inequitable in the case of *Commissioner of Internal Revenue v. Lamont,* 156 F. 2d 800. The Commissioner used taxpayer's argument in that case to prohibit partnership capital losses being offset against individual capital gains under the Revenue Act of 1936. The result there was that the taxpayer paid more tax, which may explain the Commissioner's inconsistent position, but certainly does not justify it.

The partnership supplement to the Revenue Act of 1936 involved in the *Lamont* case did not provide for the segregation of capital gains and losses of the partnership as does the 1939 Revenue Code here involved. The 1936 Act was silent as to whether capital gains and losses should be segregated at the partnership level and aggregated with the individual partner's capital gains or losses, the same as the Revenue Code of 1939 is silent as to the segregation and aggregation of 117(j) transactions. (See Secs. 181 to 188 Revenue Act of 1936, titled 26 U. S. C. A. Internal Revenue Acts, 1924 to date, pages 897 and 898.)

The Commissioner argued there that partnership capital gains and losses, *i. e.* 117(a) transactions could not be segregated and aggregated with the individual partner 117(a) transactions. The Second Circuit Court of Appeals at page 804 stated "The elimination of Section 186 of the 1932 Act . . . rendered any further prohibition of a deduction unnecessary in the 1934 and 1936 Acts" and did not allow the taxpayer there to deduct partnership 117(a) losses from his individual 117(a) gains. Section 186 of the 1932 Act read as follows:

> "In the case of the members of a partnership the proper part of each share of the net income which

consists, respectively, of ordinary net income, capital net gain, or capital net loss, shall be determined under the rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership and shall be taxed to the member as provided in this Supplement, but at the rates and in the manner provided in section 101(a) and (b), relating to capital net gains and losses."

If the elimination of the above section allowing segregation of partnership 117(a) gains and losses from the 1932 act brought about the disallowance of the aggregating of partnership 117(a) and individual 117(a) transactions in the *Lamont* case, then the fact that there is no section in the 1939 Revenue Code allowing the segregating of 117(j) partnership gains and losses with 117(j) individual gains and losses should prevent the Commissioner here from forcing the aggregation of 117(j) partnership and 117(j) individual transactions.

II.

The Decision Is Contrary to the Intent of Congress.

117(j) requires that the gain or loss from the sale of certain assets, such as those involved herein, be treated as a deduction from ordinary income or as a capital gain depending upon whether the total sales of 117(j) assets result in a gain or loss for the year in question. Since we are dealing with two accounting entities, *i. e.* the individual taxpayer and the Arrowhead Springs partnership, and since Congress provided that a partnership must report its income as an individual (Sec. 183 Int. Rev. Code of 1939 as amended), it is logical to presume that Congress anticipated that the 117(j) transactions in the one accounting entity would result in a gain and

in the other a loss, and, hence, treatment in the first entity as capital gain and treatment in the second as an allowable deduction from gross income.

Evidence of the fact that Congress anticipated and intended this result is the manner in which Congress provided for the handling of charitable contributions. Congress knew that if it did not provide for special treatment of charitable contributions in Section 183 of the Internal Revenue Code of 1939 as amended that the partnership, in computing its return as an individual pursuant to Section 183, would be allowed a deduction up to 15 per cent of its gross income; and that each individual partner, when he carried over his distributive share of the partnership net income into his individual return pursuant to 182 of the Internal Revenue Code of 1939 as amended, would get the benefit of the maximum deduction at the partnership level, in addition to which he would also get the benefit of the maximum deduction in his individual return and that the net result would be an allowance to partners of an amount in excess of 15 per cent of their gross income from all sources as an allowable deduction for charitable contributions. Congress did not want the taxpayer to be able to make charitable contributions through a partnership and individually and be able to get a deduction in excess of 15 per cent of the individual partner's gross income from all sources and, hence, included subsection (c) to 183 of the Internal Revenue Code of 1939 as amended providing as follows:

> "(c) Charitable contributions.—In computing the net income of the partnership the so-called 'charitable contribution' deduction allowed by section 23(o) shall not be allowed; but each partner shall be considered as having made payment, within his taxable year, of his distributive portion of any contribution or gift, payment of which was made by the partner-

ship within its taxable year, of the character which would be allowed to the partnership as a deduction under such section if this subsection had not been enacted."

Further evidence of the intent of Congress that there was to be no aggregation of partnership items with the individual partner's items of the same kind unless specifically provided is the treatment of credits against net income in Section 184 of the Internal Revenue Code of 1939 as amended. It is significant that Section 184 was amended on October 21, 1942, the same date as the addition of subsection (j) to 117. The second sentence of 184, added in 1942, makes it clear that nothing but *net* income or loss and capital gains and losses are to be segregated on the partnership return and, hence, aggregated with the individual partner like items and that there is to be no aggregation of other items, such as 117(j) items between the partnership and the individual partners unless specifically provided. The second sentence of Section 184 provides for the reducing of the credit allowed to the individual partner by Section 25(a)1 and 2, by the amount of the individual partner's distributive share of the deduction taken by the partnership under Section 23(v). This would not have been necessary at all if the Court's interpretation of the partnership sections is correct. Compare the converse of the case at bar, *i. e.* partnership net losses in 117(j) transactions and individual gains with Section 184 and it becomes clear that a deduction granted to the partnership pursuant to 117(j) is not segregated from the partnership return and aggregated with similar individual transactions without a specific requirement that it be done such as is provided in effect by Section 184.

Section 189 of the Internal Revenue Code of 1939 as amended similarly treats net operating losses.

Further evidence of Congressional intent that there be no aggregation of partnership and individual partner's transactions unless specifically provided is the treatment of the standard deduction in Section 183(d) of the Internal Revenue Code of 1939 as amended. Unless a partnership was prohibited from taking the standard deduction of 10 per cent of gross income, individual partners would be able to have an overall standard deduction in excess of the $1000 or 10 per cent of their gross income from all sources. For example, assume a partnership with $10,000 gross income in the taxable year in question and a partner owning 50 per cent of the partnership. If the partnership were allowed the standard deduction, then the net income of the partnership would be $9000, and the individual taxpayer's distributive share thereof would be $4500. Assuming that the individual partner had $5500 of income from other sources, his gross income reported on his individual return would be $10,000 for the year in question, and taking the standard deduction, he would subtract therefrom $1000 and pay a tax based on a net income of $9000. He would have been allowed $1500 of deductions from income from partnership source and other sources, whereas the standard deduction provision, 23(aa) allows an individual taxpayer a maximum of $1000 or 10 per cent as a standard deduction, whichever is less. To prevent a taxpayer from receiving more than the 10 per cent or $1000 standard deduction, Congress thought it necessary on October 21, 1942, to add subsection (d) to 183 of the Internal Revenue Code of 1939 as amended reading as follows:

> "(d) Standard deduction. In computing the net income of the partnership, the standard deduction provided in section 23(aa) shall not be allowed."

It is again significant that the passage of subsection (d) to 183 was in the same year that subsection (j) to 117 of the Internal Revenue Code was added, namely, October 21, 1942.

The decision of this Honorable Court has the effect of an amendment to the partnership supplement, which we may characterize by use of the following hypothetical code section, to wit Section 192 of the Internal Revenue Code of 1939 as amended:

> "192—117(j) *Partnership Transactions*
>
> "(a) In computing the net income of the partnership, the deduction allowed by §117(j) if the net 117(j) transactions result in a loss for the year involved shall not be allowed to the partnership, but each partner shall be considered as having sustained his distributive portion of the net loss within his taxable year, which was in fact sustained by the partnership and which would be allowed to the partnership as a deduction under 117(j) if this subsection had not been enacted.
>
> "(b) In computing the net capital gains or losses of the partnership pursuant to §183 subdivision 2(a), the treatment as capital gains of the net gains of items mentioned in §117(j) shall not be allowed to the partnership, but each partner shall be considered as having sustained his distributive portion of the net gain within his taxable year, which was in fact sustained by the partnership and which would be treated as a part of the partnership capital gains or losses if this subsection had not been enacted."

Had Congress passed a section as characterized above the taxpayers herein would not quarrel with the results of the Court's opinion, but we find no such provision in any Internal Revenue Act.

There is no reason for the special subsections dealing with the charitable contributions and the standard deduction in Section 183 of the Internal Revenue Code of 1939 as amended, nor for the passage of Sections 184 and 189 of the Internal Revenue Code of 1939 as amended if this Honorable Court is correct in its interpretations of the applicable partnership sections to the case at bar. The passage of the said code sections was unnecessary if the same results could be accomplished by judicial decision. Such results we urgently and respectfully submit cannot be accomplished without violence to the very essence of our system of taxation by law.

Furthermore, the computation of the partnership net income or loss and net capital gain or loss on the partnership return was an idle act if this Court's decision stands. After having computed the partnership net income or loss and capital gain or loss in accordance with Sections 182 and 183 of the Internal Revenue Code of 1939 as amended, and after using the forms provided by the Government to so calculate the partnership net income, the individual taxpayers are supposed to ignore or disregard the computation. In the event that the partnership had a net gain from partnership 117(j) transactions, each partner would be required to re-compute the partnership's capital gain or loss in order to report his distributive share thereof, and in the event the partnership had a net loss from 117(j) transactions, each partner would be required to re-compute the partnership net income or loss in order to report his distributive share thereof on his individual return.

The incongrous results of this Court's decision outlined above are best seen by looking at the partnership returns and the individual returns in the case at bar. The com-

putation of partnership income on the forms provided by the Commissioner to the taxpayers herein would have served no useful purpose whatsoever except to provide an interesting mental exercise for accountants or attorneys if the Court's decision is correct. The returns do not provide for segregating of 117(j) transaction by the partnership and the computation of the Arrowhead Springs partnership's net capital gains for the years in question must be ignored.

Is it not fair to presume the Commissioner had a different view of the intent of Congress than he is urging herein at the time he caused the forms to be prepared upon which the respondents here reported their 1948 and 1949 income?

III.
The Neuberger Case Is Not Contrary to the Taxpayer's Position.

The Court's decision, as well as the Fifth Circuit's decision in the *Ammann* case, both of which reversed the Tax Court, rely on *Neuberger v. Commissioner,* 311 U. S. 83. The *Ammann* case involved the converse factual situation to the case at bar, *i. e.* partnership 117(j) losses and individual 117(j) gains.

The *Neuberger* case involved the question of whether under the 1932 Revenue Act a partner could offset his individual losses from the sale of securities against his distributive share of partnership gains from the sale of securities. The converse was decided in the companion case, *Mosbacher v. United States,* 311 U. S. 619, *i. e.,* the offsetting of partnership losses against individual gains. Both cases involved the 1932 Revenue Act, which specifically provided in Sections 185 and 186 thereof that

"In the case of members of a partnership the proper part of each share of the net income which consists" of earned income, ordinary net income, capital net gain or capital net loss "shall be determined under the rules and regulations to be prescribed by the Commissioner with the approval of the secretary" and should be taxed to the member as provided in this supplement.

As distinguished from the 1939 Revenue Code, the 1932 Act did not provide a formula indicating the Congressional intent with reference to what parts of partnership income were to be aggregated with the individual partner's income. The 1932 Act instead left that determination to the discretion of the Commissioner with the approval of the secretary in the rather ambiguous language of Sections 185 and 186.

Hence, the whole theory of the 1932 Act was to leave to the Commissioner the problem here involved and involved in the *Neuberger* case whereas the 1939 Revenue Code specifically spelled out a definite formula for the taxing of a partner's share of partnership income in Sections 182 and 183. Nothing was left to the discretion of the Commissioner and there is no longer the reference to the "proper part" of income. Congress decided which parts of partnership income would be taxed to the individual partners. Congress in the 1939 Revenue Code specifically provided that *net* income or loss and capital gains and losses would be segregated on the partnership return and each partner's distributive share thereof aggregated with like items on his individual return. Congress did not provide that 117(j) transactions should be segregated and aggregated with the individual partner's 117(j) transactions.

As discussed at pages 7 through 10, *supra,* the intent of Congress that 117(j) transactions not be aggregated with like individual transactions is seen from the specification of specific items that were to be aggregated. The *Neuberger* case, therefore, dealing with the 1932 Act, which did not involve a formula, cannot be used as authority for the case at bar involving the 1939 Revenue Code with a specific formula provided by Congress. An analysis of the *Lamont* case, *supra,* page 5 demonstrates the correctness of this argument. The Second Circuit Court of Appeals there analyzed the *Neuberger* case in the light of the difference between the 1932 Revenue Act and the 1936 Revenue Act, and the analysis is helpful to this Court although the 1939 Revenue Act here involved spelled out Congress's intent much more specifically than did the 1936 Act involved in the *Lamont* case.

The Second Circuit at pages 802 and 804 analyzed the *Neuberger* case as follows:

> "Both taxpayer and the court below stress the omission of the 1933 amendment from later acts; but their chief reliance is upon the Neuberger case, *supra.* In fact taxpayer originally did not claim the deduction, but filed a claim for refund based upon that decision after its announcement in November, 1940. In relying on this case they are forced to the interesting analysis of having to repudiate as ill-considered dictum what the opinion says about the course of legislative history, here important, in order to stress what they consider the implications of the actual holding. That case and the companion case of Mosbacher v. United States, 311 U. S. 619, 61 S. Ct. 167, 85 L. Ed. 393, concerned income taxes for the year 1932, turning upon the converse of the case here, *i. e.,* the offsetting of individual stock losses against partnership profits. As we have seen, these

were not 'capital assets' as the law then stood. The Court, three justices dissenting, allowed the deduction. This was a reversal of the decision below, *Neuberger v. Commissioner of Internal Revenue,* 2 Cir., 104 F. 2d 649, which followed *Johnston v. Commissioner of Internal Revenue,* 2 Cir., 86 F. 2d 732, 734, certiorari denied 301 U. S. 683, 57 S. Ct., 784, 81 L. Ed. 1341, where this court had held that under the 1932 Act the partnership was a 'tax computing unit,' and that the 1933 amendment was only 'inserted out of abundant caution when that law was passed and as but a clarification of existing law.' The Supreme Court said, however, 311 U. S. 83, 88, 61 S. Ct. 97, 101, 85 L. Ed. 58, that in this Act 'Congress recognized the partnership both as a business unit and as an association of individuals' and, finding no specific prohibition of the deduction of individual losses from the partner's distributive share of partnership income, held it allowable. And this, so the argument goes, leads to a like holding in the converse situation here in view of the omission of the 1933 amendment from later acts.

"But the Supreme Court itself had a different interpretation. It held its conclusion to be 'confirmed by the action of Congress since 1932.' Citing first the 1933 amendment as reaching 'the converse of the instant case' (*i. e.,* the case here), it continued: 'More significantly, in 1938, after the Treasury Department had ruled to the contrary (citing the Treasury Regulations, *infra*), Congress expressly provided for the deduction of individual security losses from similar partnership gains (citing the 1938 Act, *supra*, and the House Committee Report, *infra*). That the amendment of 1933 changed and the Revenue Act of 1938 restored the law of 1932 as we have explained it is plain from the legislative history

of the two Acts and of §23(r)(1).' *Neuberger v. Commissioner of Internal Revenue, supra,* 311 U. S. 83, 89, 90, 61 S. Ct. 97, 102, 85 L. Ed. 58. . . .

"Thus the Subcommittee of the Committee on Ways and Means gave the correct explanation for the elimination of the 1933 amendment when it said that this provision 'was not retained by the Revenue Act of 1934 for the reason that the elimination of section 186 of the Revenue Act of 1932 by the 1934 Act, which permitted the allocation of partnership capital net losses to the individual members, rendered such provision unnecessary.' The report goes on to point out that the partnership net income was determined in the same manner as that of the individual and thus subject to the provisions of §117(a) and the limitations of §117(d) of the 1934 and 1936 Acts. 'The net result was that the net capital losses realized by partnerships were no longer available to the individual partners as offsets against either their ordinary incomes or their capital gains.' Proposed Revision of the Revenue Laws of 1938, Report of the Subcommittee of the Committee on Ways and Means, 75th Cong., 3d Sess., 43, 44. This recommendation was adopted by the full committee, which noted the 'departure from the principle adopted in the Revenue Acts of 1934 and 1936 to the extent that it enables capital net losses of the partnership in the respective categories to be applied, on the basis of the partners' allocable shares thereof, to offset their individual capital net gains in the same categories.' H. R. Rep. No. 1860, 75th Cong., 3d Sess., 42, 43, reprinted in 1939-1 Cum. Bull. (Part 2) 728, 759.

"Conceding their trend and meaning, taxpayer and the Tax Court discount the interpretative value of these later actions by Congress, though they were relied on as persuasive in the Neuberger case itself.

See also *United States v. Stewart,* 311 U. S. 60, 64, 61 S. Ct. 102, 85 L. Ed. 40. It is also suggested that they were induced by the lower court decisions which were disapproved in the Neuberger case. But the reports themselves show that they go on a different rationale, the one in fact which we accept and adopt. That is in short that the elimination of §186 of the 1932 Act and the change in system of computing and allocating capital net losses and gains, including the specific allowance of the $2,000 deduction, rendered any further prohibition of a deduction unnecessary to make clear the intent of the 1934 and 1936 Acts."

Conclusion.

The partnership sections of the Internal Revenue Code of 1939 as amended provided a clear formula in Sections 181, 182 and 183 thereof, which the taxpayers herein followed. The consequence of that formula when the ambivalent nature of 117(j) was applied to it in terms of more or less taxes should not control this court's interpretation of the statutes involved. The Commissioner adopted substantially the same position as taxpayers here in the *Lamont* case, *supra,* at page 5, where the consequence was more revenue to the Government. The United States Supreme Court in the *Neuberger* case, dealing with a prior Revenue Code which was silent as to the *parts* of partnership income which were to be included in the individual partner's computation of his net income, resolved the problem in favor of the taxpayer. If there were any doubt in the case at bar, that doubt should be resolved in favor of the taxpayer in view of the prior decisions and the fact that we are dealing with the imposition of additional taxes on taxpayers.

We respectfully urge that in view of the Internal Revenue Acts, beginning with the 1932 Act, the legislative history of said acts, the *Lamont* case, and the United States Supreme Court decision in *Neuberger v. Commissioner,* that this Honorable Court should reconsider its opinion rendered herein and grant respondent's Petition for a Rehearing.

Dated, 11th day of May, 1956.

Respectfully submitted,

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Certificate of Counsel.

I hereby certify that I am one of the counsel for respondents and petitioners in the above-entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact, and that said petition for a rehearing is not interposed for delay.

Dated, May 11, 1956.

Dudley K. Wright,
Attorney for Respondents and Petitioners.